

24 June 2016

Subject: EBF draft response to the BCBS consultation on internal models

The EBF welcomes this opportunity to participate in the international debate on the use of internal rating based (IRB) models for regulatory purposes. The European banking industry has always shown continued commitment to the development of harmonised regulatory standards that pursue financial stability and, at the same time, respect banking business and risk management practices, including the use of advanced models. European banks collaborated with the Basel Committee and their supervisors in the definition and adoption of the Basel II Accord as a global standard for capital adequacy overcoming the limitations of the previous standard of Basel I.

This EBF response paper is organised in three parts:

- Key points, in general and in particular;
- General remarks;
- Specific comments in the order of the consultative paper.

Key points

In general:

- As a matter of principle, good risk management practices should always take priority over the fair objective of simplicity.
- A prudential framework closely integrated with the business is more reliable, less burdensome and more sustainable over time.
- Work needs to continue in the direction of tackling the sources of inexplicable variation.
- The QIS results should be broken down by portfolios and jurisdictions for a well-informed decision process.
- Too many floors add complexity, hamper comparability and eliminate risk sensitivity.
- Coordination with the new accounting framework is necessary.

In particular:

- The Advanced IRB approach should be permitted for the entire corporate asset class if certain conditions are met that ensure sufficient data for modelling.
- Should the IRB approach be eliminated for bank exposures, a granular set of buckets should be defined to keep some risk sensitivity and the standardised risk weights should be reviewed not to be too conservative.

- Should the IRB approach be eliminated for equity exposures, a granular set of buckets could be defined to keep some risk sensitivity.
- The IRB approach should be permitted for Specialised Lending if certain criteria are met that ensure sufficient data and modelling techniques; for those that move to Supervisory Slotting approach a more granular risk weight bucketing for these exposures is needed, especially in the low risk segments.
- Should the IRB approach be eliminated for specialised lending, the current Supervisory Slotting Approach (SSA) could be used with a more granular set of buckets.
- The case of subsidiaries of large groups should be carefully studied and guidelines elaborated to identify the level of support from the parent company.
- The combined effect of this consultative paper and the revised Standardised Approach for credit risk needs to be evaluated.
- Data pooling could be used to preserve the use of the IRB approach where individual banks data is insufficient.
- The BCBS should reconsider the introduction of output floors. They overlap with the leverage ratio, add complexity, hamper comparability and remove the right incentives for prudent risk management.
- In the case that the BCBS decided to introduce input floors, they should be defined at portfolio level to minimise the distortion of the risk profile of individual clients and exposures.
- The LGD modelling should be defined in accordance with the bank's recovery practice.
- The time horizon for the estimation of the EAD should be left to each bank's modelling choice.
- The 50% haircut to non-financial collateral (including real estate) for A-IRB fully and partially secured exposures should be reviewed.
- The concept of unconditional cancellable commitment (UCC) needs to be examined and defined. There should be guidelines to identify those UCC that should keep the 0% risk weight. In particular, it should be made clear that risk limits and unadvised facilities are not commitments. At last, accounting standard should remain the reference of the calculation of RWA.

General remarks

Investment in good risk management practices

The development and implementation of Basel II was a major undertaking with benefits for the market in terms of increased information and good risk management practices. Banks have made a significant investment in capacity and knowledge to build up expertise with internal risk models, which also has created a common and prudent perception of risks. In accordance with the spirit and letter of the Basel II Accord, an internal rating system comprises all of the methods, processes, controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates. That is where the key value of internal risk models lies.

Business integration of prudential requirements



At this point the Basel III reform heads towards completion. In the EU, the single rule book is being rolled out through the new standards from the European Banking Authority (EBA) and through recommendations from the ESRB as well as the common supervisory practices that the ECB is deploying throughout the Eurozone. The EU has moved a long way towards convergence. In terms of changes to the capital ratio, the numerator has been transformed with significant changes both to the quality and quantity of capital. Recently, the Basel Committee has been considering further changes to the capital ratio, this time to the denominator, namely through the revision of the standardised approach for credit risk and conceptually new constraints in the use of internal model approaches. This is apart from the introduction of a leverage ratio and revisions to the market risk framework and to the approaches to operational risk. This part of the reform is controversial as it dissociates the way banks manage and organise their businesses and the prudential requirements.

Tackle the sources of inexplicable variation

The Committee could consider tackling the unexplained sources of variation instead of removing the whole model. For instance, defining homogeneous input parameters through technical guidelines and providing guidelines for the estimation of risk parameters would assist. In Europe, the European Banking Authority has launched a comprehensive plan encompassing several aspects of model building, aimed at removing only the undesired sources of RWA variability. We think this is the right approach.

Increasing focus on common predefined minimum capital adequacy output values and parameter levels is a set-back as it shifts the focus away from modelling development and, consequently, reduces the need for future modelling development as the expected supervisory outcome is already set. However maintaining the focus on IRB methodology and model development and practices would benefit oversight and draw attention to banks' real risk characteristics.

The European banking industry remains committed to collaborating with the Basel Committee in the expectation of a considered revision of internal models that addresses the issue of undue variation in risk weighted assets using internal models. We consider this can be done while retaining the positive effects of the internal model approaches that reflect local economic and structural features on exposures as well as bank specific information and risk management practices.

Breakdown of QIS results

All in all, there are several very active regulatory tracks under way. It is very important, that the implementation is done carefully and with a holistic approach in order to take the interplay of the different measures into account and to ensure that the Committee's objective of not significantly increasing overall capital requirements is met. But we also encourage the Committee to analyse and disclose the result of the QIS on a portfolio basis and on a geographical basis. We would emphasize the challenges banks are facing due to the regulatory uncertainty in which we are forced to operate. The fact that the impact of the new IRB is so closely tied up with the revision of the standardized approach for credit risk whose finalizations will occur concurrently affects banks' ability to make long term strategies with negative effects also on lending to the real economy.

In general, the proposed constraints on the use of the internal model approaches, including the proposed parameter floors and the removal of the IRB approach for financial institutions, large



corporates, specialised lending seems to make capital requirements more conservative. The impact on portfolios like project finance, trade and commodity finance, leasing and rural lending should also be assessed as these portfolios cover economic functions that could be significantly affected by higher capital requirements in spite of back tests indicating current lower levels. As this is not the stated objective, we await the results of the QIS to ascertain whether the current proposals actually maintain the same level of capital requirement for European banks.

Too many floors

The combination of floors and the Leverage Ratio creates a labyrinth of multiple backstop measures that would wipe risk sensitivity out and complicate the understanding of the true risk profile.

According to the consultative document on internal models the BCBS is still considering an overall capital floor based on the standardised approaches to be applied for banks using internal models. Introducing a capital floor on top of the proposed measures to reduce undue variation in risk weighted assets in combination with the introduction of a minimum leverage ratio by 2018 would be a glaring example of excessive regulatory overlap, which should be avoided. The EBF has in its responses to the previous consultations from the BCBS on the revisions to the Standardized Approach for credit risk (released in December 2015) and on Capital Floors (released in December 2014) pointed to the negative effects for the risk sensitivity and comparability of capital requirement by introducing such a capital floor in itself, notwithstanding the issue of regulatory overlap.

The paper proposes constraints that conceptually change the assumptions and principles that lie behind the use of internal model approaches with the objective of reducing the variation in credit risk-weighted assets (RWA). Floors on input values as well as output values lead to a supervision-based fixed level of risk sensitivity that may readily from the bank's risk profile and the built-in risk sensitivity functions of the models. Variability in risk weights across countries and banks is influenced by market and portfolio characteristics, internal model approaches, banks' model choices, supervisory practices and divergent supervisory guidance. The reduction of this variation is seen as an objective in itself, without reference to the substantial body of work from both regulatory and industry sources establishing both the validity and desirability of the majority of RWA-variation. This body of work has established that the most material drivers of unjustified RWA-variations are differences in interpretation of the requirements of the IRB-approach or differences in allowed choices within the approach. By emphasizing the usage of floors, less flexibility is offered in estimating the actual risks (and mitigation), which will affect the use test (e.g. risk appetite, pricing, deal structuring).

We support the Basel Committee objective of addressing the problems associated with the variability of internal risk model results, but we disagree on the use of parameter floors and the proposed restrictions on the use of internal model for certain portfolios.

More work on fixing the models

In 2015 the EBA had started an all-encompassing revision of the IRB approach. According to the authority, the lack of comparability and high variability of the internal model outcomes, a crucial issue indeed, needed to be duly addressed to restore confidence in the framework. At this point, the new definition of default is under finalization and new consultations on LGD and PD calibrations and CRM will follow in the upcoming months. The revised EBA's framework



should be implemented by 2020 (at the latest), hence we are concerned on the potential inconsistencies and duplication of efforts that may arise from the BCBS extensive revision. To begin with, the BCBS QIS has been run with a definition of default that will likely become obsolete prior to the implementation of the input floors proposed in this consultation. Hence we would recommend that the Basel Committee takes duly into account this issue when analysing the QIS results.

The IRB framework should, in principle, be applied to all portfolios of a bank. Implementing hybrid methods such as a mix of floors or approaches gradually weakens banks' confidence and motives to further improve risk methods, management and to apply for the use of internal models. EBF believes that improving the internal methodology in the future is conceptually correct and a sound way of also meeting future risk and calculating capital adequacy levels. External and unquantifiable risk should not be included through add-ons in the internal models and should be continued to be added as buffers based on banks' risk weighted assets.

EBF believes that there is a large potential for increasing transparency and reducing variability by reducing modelling options as well as implementing more consistent supervisory practices. The objective to achieve increased transparency must not be pursued at the cost of weakening internal models, which would result in reduced oversight and weakening of the measurement of banks' internal risks. Achieving effective and comparable RWA computation should be based on recognised, risk based models, not on template based or fixed output values or risk weights. The IRB concept will and should, however, always result in explainable and motivated differences in risk weights. Model add-ons and layers of conservatism related to model uncertainty, model risk and cyclicity also hamper comparability across countries. EBF believes that developing meaningful models is a better way of regulating the capital adequacy framework.

Coordination with the new accounting framework

Recently the accounting standards have adopted modelling practices to become more risk sensitive. There may be a lack of symmetry between the provisioning practices in the accounting and the capital adequacy frameworks. While IFRS9 promotes greater use of internal model outputs for the purpose of accounting and provisions, in particular forward loss estimates, the BCBS proposes to decrease the usage of IRB models. This raises a fundamental question: if not all credit risk exposures can be modelled reliably or consistently for use in determining regulatory capital requirements:

- Should we discard the use of provisioning models for these portfolios?
- Is it acceptable that a portfolio be subject to models for provisions and not for capital?
- How can we compare IRB floored parameters with the provision level that is calculated under a true and fair approach?

In general, the floors system proposed seems to make capital requirements more conservative and is in particular focusing on the low risk exposures. Penalizing high quality exposures, and at the same time weakening the relation with the underlying risk, does not contribute to an overall stronger capital adequacy framework. As indicated earlier, we await the results of the QIS to ascertain whether the current proposals actually maintain the same level of capital requirement for European banks. However, our own preliminary estimates show that the combined effect of all the BCBS regulatory reforms would not be capital neutral in spite of the Committee's declared objective not to significantly increase capital requirements.



Comments on the BCBS proposals

1. Scope of use of internal models

- We acknowledge that the proposal to step back to the standardized approach for low data portfolios (like income producing real estate - IPRE) results from the internal models presumed inability to produce robust estimates in the absence of a significant pool of data. However, the extensive information and data that banks have about these portfolios should not be neglected. The default data is often complemented by a variety of risk management information which strengthens the overall risk assessment. Hence we would propose that the regulator defines more stringent modelling methodological standards and stress the margins of prudence that address the issue of scarcity of default data at bank level, without recourse to the use of the standardised approach. This could also include the possibility of data pooling within supervisory restraints.
- The decision to use internal rating based models should be based on the existence of good quality data that exceeds certain and harmonised minimum levels of yearly observations. If these criteria are met, the institution will be able to build internal models, which could be used for pillar 1 regulatory capital allocations once other criteria on modelling (including back-testing) are met. It can well be that institution A with a large corporate portfolio has sufficient internal loss data to build a robust internal model, while institution B does not have the minimum required loss data. Therefore, these decisions should be made based on the availability of data and therefore should not deny a complete exposure class or subset thereof. These minimum levels should not be subject to supervisory discretion.
 - a. Specialised lending**
- Specialised lending, and mainly Trade and Commodity Finance, Project Finance, Ship Finance and IPRE, would be particularly penalized by the current Basel Committee's proposal, irrespective of the fact that these activities generally represent a catalyst for the entire economy, in particular during the recovery phase following a downturn. Many banks will have sufficient default data strengthened with risk management data to construct IRB models. If sufficient data is available, banks should be permitted to use these models.
- We consider that risk-sensitive capital requirements for specialised lending are paramount. Capital requirements that fail to reflect actual risk levels are likely to make these products uneconomic, with negative consequences for end-users and economic growth. Indeed, it is necessary to ensure adequate levels of funding for all forms of long-term financing for the economy, especially for infrastructure and other investments that support long-term growth. This would avoid undesired effects such as the crowding out of financial institutions or their movement to riskier projects to obtain the necessary profitability to meet their cost of capital.
- By definition, specialized lending is a non-standardised business and therefore flat risk weights are not appropriate to reflect the underlying risk profile of these assets and their idiosyncratic features (e.g., the structured and highly collateralised nature of these products and the existence of different types of collaterals, long loan maturities, different sponsors and developers, etc.).



- The characteristics of a project can be very different from one another; therefore, the analysis and individual valuation of each project, through an individual internal rating process, is key to adequately reflect the underlying risk profile and determine the capital requirements. Consequently, we support the use of IRB approaches for the calculation of the regulatory capital for this portfolio.
- The current supervisory slotting approach is not sufficiently sensitive to function as an appropriate alternative approach were conditions for using the IRB approach are not met. The risk of the underlying project, as it only generally offers the possibility of assigning only two different risk weights for calculating the capital requirements of a new long-term project: 70% (Category 1 Projects) or 90% (Category 2 Projects), thus providing very limited risk sensitivity with regards to the underlying project (Risk weights of Categories 3 to 5 apply to existing projects whose credit rating has deteriorated). In addition, the supervisory slotting approach does not fully recognise the guarantees for risk mitigation. For instance, the guarantees of an Export Credit Agencies (ECA), European Investment Bank (EIB) or Multilateral Guarantee Agency (MLA) could only be used as a factor considered for assigning risk weights to specialised lending exposures but could not be used as a post-mitigation technique.
- We consider that the IRB model should be retained for specialised lending especially considering that it is not necessarily a low default portfolio. In any case, the current supervisory slotting approach should be reviewed in order to increase its risk sensitivity and thereby adequately reflect the underlying risk of infrastructure projects as well as the risk mitigation techniques:
 - A full scale of risk weight buckets should be introduced, based on the experience gained from internal models, so they can be tailored to recognise the specific features of the underlying exposures to more accurately reflect risk.
 - The related risk mitigation techniques should be fully taken into account when determining the capital charge. Indeed, the current slotting approach does not fully consider risk mitigation techniques, discouraging a sound and active credit risk management for this portfolio. For instance, the mitigation effect of following guarantees is not recognised in the current slotting criteria:
 - An ECA guarantee implied in a Project Finance is considered in the rating of the transaction when assigning the risk weight, resulting in a 70% risk weight which is associated to the lowest category. However, the guarantor of this transaction is an ECA (sovereign guarantee) and the risk is supported by the guarantor, therefore this transaction should be treated accordingly, resulting in most cases, in a 0% RW.
 - The EIB funded guarantees that are used to transfer the risk of a Project Finance to the EIB which promotes financing initiatives of real economy. Indeed, the cash collateral cannot be used as a risk mitigant for project finance as banks cannot either replace the PD of the exposure with the guarantor's borrower grade (i.e. a full substitution approach) or modify the LGD (real guarantees) of the Project Finance.
 - The current Supervisory Formula Method cannot be used for unrated positions of securitisations where the underlying exposures securitised



are project finance under the supervisory slotting approach. Therefore, banks are forced to rate these securitization positions and to apply the Rating-Based Approach (RBA) to calculate the capital requirements. This makes the securitization too costly and inefficient in terms of cost comparing to the capital relief achieved. So, there is no possibility of transferring the risk of Project Finance to the market, discouraging the investment in type of assets.

- Additional granularity depending on the maturity of the project should be included. Based on our internal experience, we propose to establish the following buckets:
 - < 2.5 years
 - 2.5 – 5 years
 - 5 - 10 years
 - 10 years

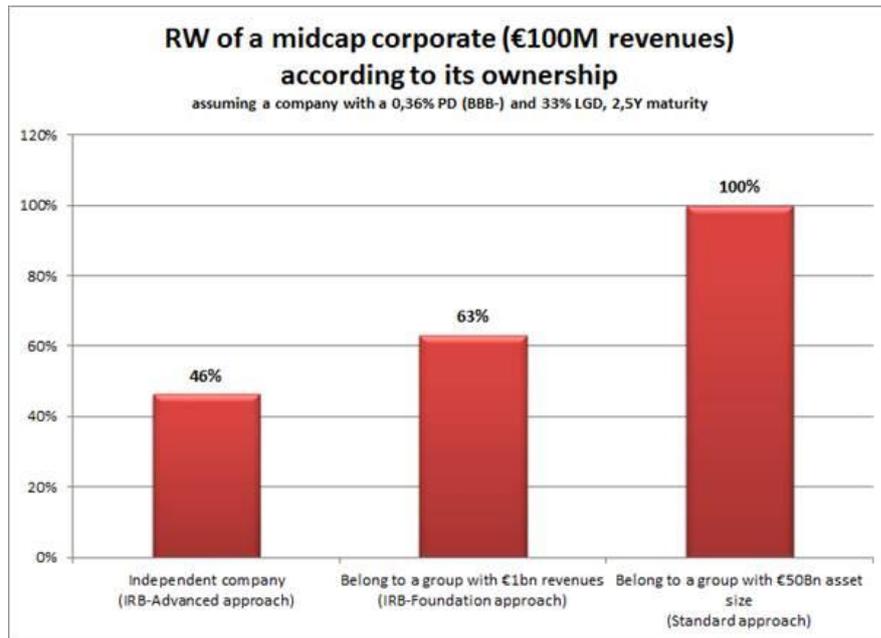
b. Exposures to banks, other financial institutions and corporates

- The proposed restrictions on the potential scope of application of the AIRB approach is far reaching, in particular due to the threshold related to corporates belonging to consolidated groups with total assets of less than or equal to EUR 50bn and annual revenues greater than EUR 200m, widespread in the European economy.
- As stated in the consultation paper, we do not see the rationale behind the differentiated treatment of large corporates with consolidated assets greater than EUR 50bn vis-à-vis all those large corporates belonging to groups with revenues greater than EUR 200m which can use F-IRB. The proposal does not consider possible unfair treatment of equal companies when thresholds are set at group level rather than at counterparty level.
- Hence we first propose the adoption of the A-IRB Approach for the entire Corporate asset class if certain conditions are met (for example the adoption of a common benchmarking to ensure sufficient data for modelling is used by a process similar to the UK *Prudential Regulation Authority*). Phasing out IRB for certain portfolios and introducing turnover thresholds are watering down the faith in models.
- The more conservative treatment assigned to large corporates with consolidated assets greater than EUR 50bn does not seem to reflect the fact that the largest exposures have stricter public disclosure requirements thus allowing banks to perform a deeper assessment of counterparty creditworthiness.
 - The use of a new segmentation increases complexity. And there is no evidence that the size of a corporate is correlated with its risk of default. We think the proposed 200 mill EUR revenue limit and the 50 bn EUR asset size limit should be carefully calibrated based upon quantitative studies of historical default rates.
- There is a fundamental question about the interpretation of the thresholds put forward by the Committee for the categorisation of corporate exposures. The vast majority of large corporates, defined in the consultative paper as holding assets above €50bn, have affiliates whose assets might be, in many cases, below the former threshold. The Basel Committee has declared that this should have a very limited impact since only 100



companies have a consolidated asset size above the €50bn threshold and the vast majority of them are externally rated. In practice the current definition of the scope of application of the SA will include all the subsidiaries of these groups, whatever their size and thus will include middle market unrated corporate, who will attract a 100% RW. This proposal will cover a substantially larger number of corporate entities.

- The following chart illustrates the inconsistent treatment for a midcap BBB-exposure depending on whether it is considered standalone or integrated in a larger group:



Alternatively, in order to overcome this major inconsistency, we suggest to apply the SA only to the companies whose asset size is above the threshold and to their subsidiaries that are subject to an explicit guarantee from their parent company, maintaining the application of the IRB to their subsidiaries as far as their total asset size is below the €50bn threshold.

Alternatively, we outline a guideline to treat subsidiaries in line with a risk assessment of the level of support they receive from their parent company, so as to not unduly penalize these. The risk drivers of this assessment could be:

- inclusion of the subsidiary in consolidated financial statement;
- percentage of the ownership and / or voting rights > 51%;
- industrial and/or commercial integration;
- economic and financial integration;
- sharing of brands;
- strategic relevance of the company for the group.



A simple rule might be that if the two first risk drivers are present, plus at least two of the others, then it is possible to apply the extension; if not, the subsidiary should be segmented and evaluated (and therefore risk-weighted) on a stand-alone basis.

We believe IRB should be preserved and improved further thanks to international and regional works already underway.

For the same reason, entities qualified as Specialised Lending structures belonging to large corporate groups should be allowed to be treated under the IRB framework. Banks have more information available to make a more accurate risk assessment. It should be encouraged to make use of this information rather than applying the SA or slotting.

- Due consideration should be given to the combined effect of both this proposal and the revision of the standardised approach for credit risk. Unrated counterparties could see their risk-weights multiplied by a significantly high factor. Especially the proposed risk weight treatment of CFFs for undrawn revolving credit facilities on corporate exposures in the Standardised approach could entail very significant increases in capital requirements for large corporate exposures that seem unnecessarily harsh in view of the stated objective of reducing undue variation in the capital treatments of similar exposures across banks using the IRB approach.

Example: *An unrated company with a long track record of immaculate credit risk performance and with good business prospects carries an internal rating based (IRB) risk weight of 30%. If the IRB model is abolished and the standardised approach remains as in the second consultative paper, then the risk weight of that company would jump to 100%. Such a situation is not acceptable, neither for the borrower nor for the bank.*

The IRB formula has a scaling component for the purpose of increasing the capital requirement. Addressing the issues in the existing capital framework via conservatism assumptions or add-ons, may serve as an alternative to applying floors or restricting usage of IRB models for low risk portfolios. This can address the exposures specifically and does not only target the low risk exposures. It would be an unnecessarily simplistic approach to abolish the internal models altogether.

- Apart from refining the proposal for the standardised approach for credit risk¹, the EBF proposes to preserve the use of the IRB Approach with the possibility of data pooling in particular for LGD and EAD (CCF). Concerning the issue of data pooling, the supervisor could be allowed to define a benchmark portfolio or let to define a shared sample (i.e. on condition that it guarantees coverage of at least 75% of the analysed segment) for the parameter estimation (PD/LGD) but let the bank calibrate on its own portfolio risk characteristics taking into account (different risk profiles and recovery practices of each Bank). Depending on the risk profile, banks may target for exposures which are better collateralised or on the other hand focus more on profitability instead of risk. While the exposure class is the same for both banks, the underlying risk is different.
- The standardized model that would be applied to exposures to banks and large corporates promotes a one-size-fits-all approach which is inconsistent with the heterogeneous nature of those asset classes. A full scale of risk weights should reflect

¹ EBF response to BCBS consultation on the revision of the CRSA (see points 8 and 13).



real risk characteristics within each asset class by diversifying, for example, the Insurances (due to the different risk drivers) and Banks (e.g. Small versus Large).

- External benchmarking (subject to approval by supervisors) would be needed to ensure appropriate mapping of internal models to risk buckets.

c. Equities

- The combination of the removal of models and the proposal for the Restrictions in the Standardised Approach leaves equity exposures in a severely penalised situation. Not only they would be deprived of the risk sensitiveness offered by IRB models but they would also be treated under a new and more conservative standardised approach. We propose to maintain the current range of IRB approaches for equities.
- Alternatively we propose to apply a highly simplified scale (but indeed more granular than current CP proposal) with risk-weights of 150%, 175% and 200% applicable based on the issuer's credit rating.

d. Counterparty credit risk and credit valuation adjustment (CVA)

- The removal of CVA IMA could increase the industry's cost of capital and pose further burdens to the derivatives market-making activity.
- The IMA approach does not introduce relevant additional complexity with respect to the standardized approach, because the main methodological challenge for both approaches is the calculation of CVA sensitivities. The calculation of the expected shortfall, even in the multi-liquidity horizon context of FRTB, is at the end only a different, and more risk sensitive, aggregation of the same set of sensitivities.
- Such additional charges are also not justified from a risk perspective since the standardized regulatory model for CVA will diverge substantially from the managerial CVA models, limiting risk sensitivity and hampering the objective of reducing the gap between managerial and regulatory CVA.
- Regarding the decision to retain internal model for CCR we argue that:
 - o The adoption of a floor based on a percentage of the applicable standardised approach will disincentive investments in internal models, reducing the risk awareness derived from the development of advanced methods;
 - o Note #10 on page 5 of the Consultation Paper (CP) is in contrast with point 119 of the consultative document "Revisions to the Standardised Approach for credit risk", where the use of the SA-CCR method seem to be mandatory for collateralized OTC transactions. Furthermore, the accounting rules still require complex models for CVA. Therefore the additional effort to implement an IMA-CVA model will be limited. Given the relevance of the possibility to continue to use CCR internal models further clarification is required.

2. Parameter floors

- We expect that the floors will hit low PD and/or low LGD high quality assets, while any possible unintended risk weight variation of PD and LGD inputs above the floors are not addressed at all. Consequently, floors provide incentives for banks to move away from good risk measurement techniques and can distort risk appetite and risk management, e.g. directing practices towards higher risk lending in order to meet hurdles for risk-



adjusted return and return on equity targets. Floors also directly undermine the investment that banks have made in developing best practice risk measurement techniques and remove the incentive for banks' further development. One significant development from the adoption of the IRB-approach has been the investment in data, systems and analytical capability with consequent benefits to the risk management within banks. Continued investment in these areas should be encouraged, not discouraged.

- Highly collateralised exposures in businesses such as Trade and Commodity Finance and leasing and rural finance will be affected by the imposed input (LGD) floors distorting the perceived credit risk on these exposures. This could even incentivize banks to take more risks on certain exposures which are considered equal (due to the same floor) from a capital calculation perspective, while in practice these are not. In particular, it should be stressed that the current proposals do not take credit risk mitigation sufficiently into account. Collateralization and guarantee structures are not incentivized which may result in higher risk level deal structures. Risk management and regulatory capital requirements do not follow the same line of thought.
- The EBF does not, in general, support the parameter add-ons. Downturn add-ons also ignore the real macro-economic factors and downturn estimates in the models. Supervisors also have divergent perception of risks resulting in different scaling of the add-ons. Taking into account stressed factors through add-ons in the normal calculations entails a double counting of stressed factors, as banks calculate possible effects and hold capital for this through Pillar 2 requirements. There is a large potential for further developing and, where necessary, limiting internal model approaches, options, and practices, which could compensate for expected output values. Thresholds do not solve sound model calculation or, in principle, increase transparency.
- For low default portfolios, the absence of a large number of observations could be addressed in a more constructive manner than by the introduction of floors. Banks should be encouraged to invest in data quality improvement and data pooling of credit loss data for low default portfolios. In the current proposal PD floors are basically envisaged for retail and corporates (excluded largest firms). Since default events for these exposures are numerous the use of floors is not necessary to secure reliable parameter estimates.
- The EBF suggests that the floors will be applied at portfolio level. Applying the floors at portfolio level instead of exposure level would achieve the objective of avoiding perceived underestimation of risks for certain exposures types as a source of undue variation across banks but at the same time preserve some risk differentiation for low risk exposures within the portfolio. Compared to an exposure level floor, this would improve incentives within banks to retain and manage low risk exposures within a portfolio.
- The proposed floors should only stay in the risk measurement framework temporarily. The BCBS should indicate in the final paper a date for the review and potential removal of floors.
- It is not clear to us if the consultation envisages a floor to be applied to the LGD downturn add-on in addition to the LGD floor. In our understanding if the LGD floor is higher than the LGD calculated with the internal models (already including the



downturn add-on), the former has to be taken as reference LGD. However, we are questioning if the consultation perhaps foresees that in the above example banks should consider the LGD floor or the LGD floor plus the floored downturn add-on. In any case this double system of floors creates an opaque and unduly complicated system to keep under control the parameters variability.

3. Parameter estimation practices: PD

- We understand that the “rating system” should encompass, as stated in the Basel 2 Accord, “all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to rating grades or pools, and the quantification of default and loss estimates that have been developed for a certain type of exposures”.

This interpretation would be in line with the current practices and would imply that the criteria used to assign obligors to a PD should remain stable over the business cycle.

- We welcome the Basel Committee proposals to limit the range of banks’ practices to estimate PD. However, we must stress that there are several sources of PD variability and heterogeneity that are not being addressed in this consultation and for which a more harmonised approach would contribute to achieving the goal of reducing variability instead of using floors. For instance, the EBA standards and works undertaken to align default definitions, PD computation, treatment of defaulted assets as well as downturn LGD, is a significant step in the right direction, i.e. contributing to comparability, reducing complexity and keeping a minimum of risk sensitivity.
- Regarding the adjustment of seasoning in the estimation of PDs for retail exposures, we consider that the proposal would undermine the inherent stability of capital requirements, which would vary considerably depending on the seasoning effect per se and may give rise to unintended consequences such as regulatory arbitrage or increasing pro-cyclicality. Moreover, we do not see the benefit of this proposal when the PDs should follow a ‘through-the-cycle’ (TTC) approach focused on a longer horizon, abstracting in principle from the current cyclical conditions. Therefore, instead, we believe that the conditions of the economic cycle for the PD should be clearly defined.
- The proposals in section 4.1 have potentially significant and far-reaching implications. There are some gaps like the consideration of model philosophy and the dilemma between through-the-cycle and point-in-time models and a mix of these. The proposals might not be actionable in a manner that will lead to a reduction in the variability of RWA.
- An example is given in section 4.1, where it is proposed that PD calibration datasets should have at least one year in ten of downturn data. This is a loose requirement, not representative of true downturns. A more stringent view of the economic cycle for PD and of the economic downturn for LGD from the Basel Committee could be considered. This would serve to promote RWA comparability through convergence in the meaning of the PD and LGD parameters.

4. Parameter estimation practices: LGD



- There is opacity in the regulations regarding the risk factors back-testing procedures. Despite the importance of having clear guidelines for all parameters, the LGD back-testing brings additional difficulties as the number of observed recoveries, restricted to the most recent years, could trigger significant challenges in assessing the Point-in-time or realized LGD and its comparison with the estimated LGD.
- Collateral haircuts for repossessed assets: given the variety of factors that concur for the computation of haircuts for repossessed assets (time to sale, prices behaviour, macroeconomic effects, interest rate, intermediation sale costs, etc.) it is fair to assume that this issue is also a source of variability on RWA, that also could be considered standardised. Further clarification and standardization is needed on these factors, not only on the abovementioned ones, but also regarding the inclusion (or not) of gains obtained and on the scope of historical information considered (just sold assets or both). In addition, the way the haircuts should be applied to incomplete collateralized operations should also be harmonised. Finally, there are cases where the national supervisor is requesting additional downturn adjustments over the haircut value, when the factors that contributed to that haircut already consider downturn conditions, which leads to a duplication of the downturn negative effect. Such an approach must be avoided and the final BCBS text should acknowledge it.
- The LGD table for eligible non-financial collateral shows a proposed new value of LGD for Other physical collateral of 25%. This value is a multiple of actual realised values of loss given default observed for financing where the underlying collateral is first-priority ship mortgages, oil & gas reserves or other commodities for which a market exists. These observed lower loss given default observations are measured over multiple cycles and include the typical volatile and cyclical character of financing these types of assets and commodities, and at the same time reflects the high recoveries as a result of the conservative structures in place when financing these assets and commodities. We also highlight the disproportionate impact expected on rural lending as well.
- EBF suggests that the floor to be applied for all other types of non-financial collateral could be 15% for all segments (Corporate and Retail).
- Alignment of the LGD computation with the bank's recovery practice: There is a high degree of heterogeneity in the way cross-default is treated on the LGD (facility approach vs. client approach). We agree that the LGD modelling should be defined in accordance with the bank's recovery practice. For example, if a bank has in place a customer-centric recovery process it does not seem reasonable to follow a transaction level modelling approach only for regulatory purposes. We would welcome that such flexibility be reflected in the final text.
- Regarding LGD for defaulted exposures, there are currently different practices across banks as to what concerns the calculation of the Expected Loss Best Estimate (ELBE) as well as the add-on parameter to cover additional unexpected losses. In addition, the way the economic environment is assessed and captured for the downturn period and the current conditions period is very heterogeneous. These differing practices would need to be addressed in conjunction with the proposed changes to LGD estimation.
- For downturn, the document seems to consider, for the AIRB unsecured exposure (section 4.2.3), a specific estimate of the Downturn parameter (as an add on component for the long-run average LGD) and, for fully and partially secured exposures (section



4.2.4), a "direct estimate" of a "downturn LGD" which has to be subject to floors (both for the secured and unsecured component) according to the reported formula: Does this mean that for fully and partially secured exposures there is no need of a specific downturn add-on because the overall "downturn LGD" is already subject to a floor?

- The specific estimate of Downturn parameter for the AIRB unsecured exposure (par. 4.2.3) is described as an add-on component. We wish to clarify if this indication ("sum of") must be interpreted as a specific model requirement or if, more generally, is an indication aimed at specifying that this component should represent an increasing factor to long average LGD. Could it be estimated through different methodologies?
- For A-IRB fully and partially secured exposures, the proposed floor is calculated as a weighted average (LGD unsecured - LGD secured). Should it be a methodological indication for developing LGD models "just" for secured vs. unsecured positions or this indication refers only to the floor calculation?
- For A-IRB fully and partially secured exposures, the proposal involves the use of the same F-IRB proposed haircuts for non-financial collaterals (substantially increased). The proposed haircut applied to the value of collateral (including real estate) of 50% appears very conservative especially given the floor-approach as described in the preceding bullet. We ask for confirmation of the correct interpretation of the proposal.

5. Parameter estimation practices: EAD and CCF

- One of the areas of major concern for the industry is the newly proposed calibrations for CCFs, with particular reference to the 50% - 75% range currently envisaged for non-retail counterparties. Apart from the fact that commitments are unilaterally cancellable without prior notice by banks, the conservatism embedded in the CCFs floor foreseen in this consultation would be compounded by the standardised approach treatment.
- The prudential treatment of UCCs deserves a holistic review. Firstly, a clear definition of unconditionally cancellable commitments has not been provided. Guidelines to identify UCCs that should keep the 0% CCF in the standardized approach are needed before imposing risk weights that could disrupt their normal functioning.
- In the recent Committee's Regulatory Consistency Assessment Programme (RCAP), the Committee indicated that the approaches to estimate EAD vary, with some banks using (a) a fixed horizon approach, where defaults are assumed to occur 12 months from the observation date; (b) a cohort approach, where obligors are grouped and defaults could occur any time over the forthcoming 12 months (or another defined period); or (c) a multiple horizon (or variable period) approach, where exposure is considered at several different intervals over the horizon period. The time horizon for the estimation of EAD should be left to each bank's modelling choice without posing constraints. From our point of view the cohort approach aligned with PD modelling technique should not be a priori forbidden. The 12-month fixed lag proposed in the consultative document creates problems in the sample definition such as the phenomenon of the increase in the exposure in between the performing and the default date. It is disputable how to treat the increase of exposure in the period between the performing date (12 months before the default date) and the default date. That increase can have an impact on the CCFs and in particular on the outliers observed in the distribution.



- On unconditionally cancellable commitments (UCC), since the paper explicitly specifies about UCC that “commitment means any contractual arrangement that has been offered by the bank and accepted by the client to extend credit, purchase assets or issue credit substitutes”, there is a significant impact of this definition on the current practices.

It should be made clear that risk limits and unadvised facilities are not commitments; likewise, there are many cases where the terms and conditions of facilities enable firms to suspend their commitments, or where the product requires the banks’ authorisation before the client can make use of the facility. In some jurisdictions, this may be considered as not being a commitment at all.

- We would need further explanations to understand the reasons that have led the Committee to subject the EAD to a floor that is the sum of the on-balance sheet exposure and 50% of the off-balance exposure using the CCF in the standardised approach: compared to current treatment the one proposed is anyway very penalizing.

It seems unwarranted to penalise non retail uncommitted credit lines by equalizing the proposed floors to those credit lines that are not unconditionally cancellable. It has to be noted that consumer protection or other laws do not have an influence on the lenders’ decision-making powers. This is particularly true in the corporate space, but can equally be the case in the consumer space where the impact of consumer protection laws does not change the nature of the commitment from being unconditionally cancellable. In such cases, reputational risk considerations do not constrain the firm in its ability to unilaterally cancel these commitments. For product types that truly allow the bank to cancel the facility at any time in practice and where there are demonstrable controls and legal rights, monitored through robust internal governance, a 0% CCF is justified, and, as stated above, supported by the empirical evidence of banks’ mean observed CCF. Moreover, in many jurisdictions these types of commitments are not even recognized in banks’ financial statements. We think that the Committee should confirm that accounting reporting should remain the unique reference for the calculation of RWA and not open any room for a divergence between the accounting reference and the risk perimeter.

- Both under F-IRB or A-IRB treatment, we are particularly concerned about the determination of the EAD for committed undrawn margins of Revolving Credit Facilities (RCFs). It should be considered that within corporate and investment banking portfolio RCFs are normally granted as back-up facilities for supporting customer’s rating needs, but they are undrawn in most cases, with very little evidence of defaults. As a consequence, the calculation of CCFs for this type of exposure using regulatory factors that set a weight of 75% for the undrawn part will materially hamper this activity (the observed level of CCFs and the one estimated with the internal model are much lower). Hence we would stress that the CCF envisaged also under the internal models are too much punitive and should be reconsidered.
- We consider that the CCF is especially influenced by internal management of the commitments (credit limits management, for example) and by their use, which differs among products and jurisdictions for retail exposures. Therefore, limiting the EAD estimates to a 12-month fixed horizon estimation approach would hamper risk sensitivity and would not be appropriate for some short-term retail products.



Moreover, this would disable the integration of the CCF into the process of risk management, credit approval and decision-making and internal capital allocation. Therefore, we consider that the use of a variable horizon estimation approach is more suitable for the estimation of this parameter.

- Whatever approach a bank uses to estimate EAD, it should confirm that the basic downturn requirement of the framework is met, i.e. the bank's estimates represent (conservative) estimates of the long-run default-weighted average EAD for similar facilities: it is necessary to clarify what is intended to be downturn EAD and how it should be estimated. According to EBF opinion it is sufficient to be compliant with the rule for PD models to have at least x years in Downturn within the historical series used for estimation purposes

6. Parameter estimation practices: Maturity

- We propose that banks calculate facility-specific maturity on the basis of the A-IRB rules, as the maturity is not considered a source of the risk-weighted assets' variability.
- The determination of the maturity parameter explicitly prohibits the use of the repayment date of a current drawn amount. The expiry date of a facility should be used instead. We believe that truly uncommitted facilities should be excluded from this proposal since for additional drawings, or extensions, under such an uncommitted facility, explicit approval by the bank on the level of individual drawings is required and banks have the legal right to reject any such request for additional drawings and this is a common practice between banks and professional corporate counterparties

7. Parameter estimation practices: Credit Risk Mitigation (CRM)

- It is not clear how to treat substitution and guarantees. Several questions need to be resolved:
 - a. How would PD substitution work when the guarantor is considered as a financial institution hence under the Standardised Approach?
 - b. How could the LGD be adjusted in a substitution approach?
 - c. How should firms treat an IRB exposure guaranteed by a Standardised Approach entity?
 - d. How should firms check that the guarantee should only be taken into account when it results in a lower risk level?
- We do not agree with the proposal to remove the option to use own estimates of haircuts from the F-IRB approach. Where reliable data are available, the ban to develop internally haircut measures seems unjustified.
- The CRM framework includes a large variety of possible methods with regard to the use of collaterals, including the so called "double default". In the consultative document, the BCBS proposes to remove the double default treatment as a credit risk mitigation technique, based on its complexity and rare application by banks. However, the double default approach recognizes the natural assumption that the probability of default of the transaction depends on the joint probability of default of the original obligor and protection provider, which is unlikely. For example, this approach is typically applied for transactions, under certain criteria, with credit risk



insurance provided by private insurance companies, ECAs or MLAs, traditionally used by banks for example in the Trade Finance Area.

Therefore, removing this approach will disincentive banks to purchase protection, which indeed makes their balances sounder, and also will reduce the provision of financing in emerging markets, where banks' capacity to provide funds is usually related to their access to the insurance market.

Additionally, with the purchase of credit derivatives we not only have the guarantee of the protection provider but also there is a cash collateral scheme, which anticipates cash when the credit quality of the underlying asset deteriorates. In fact, this extra-collateral is not taken into account so there is no point in eliminating the double default treatment, penalizing the capital mitigation and discouraging the acquisition of credit hedges to manage credit risk.

Therefore, it is crucial that the double default approach remains as a credit risk mitigation technique. In order to address the complexity in the application of the double default, we suggest the BCBS to simplify the requirements to apply this method.

